Northland
Energy Trading LLC

February 22, 2011

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David A. Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Entity Definitions (RIN No. 3235-AK65)

Dear Mr. Stawick:

Northland Energy Trading LLC ("Northland") respectfully submits these comments in response to the December 21, 2010 joint proposed rule ("Proposed Rule")[1] issued by the Commodity Futures Trading Commission (the "CFTC" or the "Commission") and the Securities and Exchange Commission (the "SEC") requesting comments on the Commission's proposed definition of "swap dealer" pursuant to Section 712(d)(1) of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act").[2]

Northland appreciates this opportunity to express its deep concerns with respect to the "swap dealer" proposal as it would apply to Northland and comparable businesses that act as aggregators of the *bona fide* hedge positions of small energy retailers and consumers. We believe that the rule, as presently fashioned by the Commission, threatens the viability of small market participants like Northland that pose no systemic risk, and it will undermine the efficiency of the retail energy markets, thereby harming consumers. We believe further that such a sweeping definition of swap dealers is wholly

[1] Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant," 75 Fed. Reg. 80,174 (Dec. 21, 2010).

[2] Pub. L. No. 111-203 (2010).

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unnecessary when applied to aggregators that contract only with eligible contract participants.

The CFTC should not burden aggregators that facilitate hedging by retailers with regulatory burdens that are equivalent to those contemplated for banks and other institutions that deal in trillions of dollars in derivatives. We urge the CFTC to narrow the proposed definition of swap dealer and broaden the *de minimis* exception. It also should develop an explicit exclusion for aggregating activities on behalf of small businesses that qualify as eligible contract participants.

I. Background

Northland is a non-financial entity that assists hundreds of home heating oil retailers and other consumers and distributors of petroleum products[3] in managing the price risk associated with the volatile energy markets in which they do business. It assists its customers with risk management by offering them simple, bilateral, over-the-counter ("OTC") swaps that enable them to cap the price they will pay for heating oil and other energy commodities. These risk management programs facilitated by Northland in turn enable the retailers to offer their residential and commercial customers "pre-buy" programs that reduce the consumers' exposure to costly price swings.

This type of price protection is critically important to the millions of Americans who use heating oil to warm their homes. Notably, although approximately 78 percent of homes in the Northeast and Mid-Atlantic are dependent on heating oil, local storage for the physical product is insufficient at the distributor and consumer level to enable the pre-purchase of seasonal demand, which is several times greater than the aggregate storage capacity in the region. As a result, households in the Northeast and New England face the risk of extremely high heating oil prices during the peak heating season between October and March each year.

By enabling retailers to cap the price of heating oil using derivatives, Northland helps protect households and small businesses from price spikes during the peak heating season. For example, in 2008, at a time when heating oil prices approached $4.50 per gallon, homes heated by oil provided under pre-buy programs saved more than 40 percent on their bills. Likewise, during the first half of the 2010-2011 winter season, the average pre-buy program has offered customers savings of up to $0.50 to $1.00 per gallon, amounting to a 14-27 percent reduction.

At its core, Northland's business is that of an aggregator. Northland's clients typically are small businesses who need to hedge volumes that are less than the standardized,

[3] In addition to heating oil retailers, Northland's customers also include propane distributors, gasoline dealers, purchasing cooperatives, convenience stores, agricultural industry suppliers, diesel dealers, municipalities, and commercial end users.

exchange-traded futures contract volume.[4] Northland aggregates its clients' individual long *bona fide* hedge positions by taking opposite short positions through OTC swaps with its clients. Having aggregated its clients' risk, Northland invariably lays off its own risk in the highly regulated futures or options markets administered by the CME NYMEX Division.[5] Northland's ability to offer customized increments depending on the needs of the client makes hedging accessible to businesses with small portfolios who otherwise could not establish a clean hedge using exchange-traded contracts.

Unlike the archetype swap dealer who typically will enter into a mixture of long and short swaps with a variety of counterparties and hedge only its net exposure, Northland always maintains a predominantly short position in OTC swaps with its clients and offsets that exposure on a nearly one-to-one basis to establish a net-zero exposure.

II. Swap Dealer

The Dodd-Frank Act provides a skeletal definition of "swap dealer" and requires that the Commission and SEC, in consultation with the Board of Governors, *shall* further define the term.[6] Specifically, as a starting point, the Dodd-Frank Act defines swap dealer to include any person who (i) "holds itself out as a dealer in swaps," (ii) "makes a market in swaps," (iii) "regularly enters into swaps with counterparties as an ordinary course of business for its own account," or (iv) "engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps."[7] In the Proposed Rule, the Commission adopts language identical to the statute's skeletal definition and provides the following interpretative guidance as to characteristics it associates with swap dealers:

- Dealers tend to "accommodate demand" from other parties;
- Dealers generally are "available to enter into [swaps] to facilitate other parties' interest" in entering into those instruments;
- Dealers tend to use "their own standard terms or on terms they arrange;" and
- Dealers tend to be "able to arrange customized terms for [swaps] upon request, or to create new types of [swaps] at the dealer's own initiative."[8]

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[4] Although Northland's customers individually may have relatively small hedge positions, each customer must represent to Northland that it qualifies as an eligible contract participant.

[5] Due to the absence of a liquid exchange-traded contract in propane, Northland lays off its clients' *bona fide* propane hedges through OTC swaps.

[6] *See* Dodd-Frank Act §712(d)(1).

[7] *See* CEA section 1a(49).

[8] *See* Proposed Rule at 80,176.

In testimony before Congress, Chairman Gensler has stated that he anticipates that approximately 15-20 entities will qualify as swap dealers, with each having 4-7 affiliates who also likely will register as dealers.[9] In other discussions, the estimate has been as high as approximately 400 entities, with approximately 198 being primary members of the International Swaps and Derivatives Association, Inc. ("ISDA") and the remaining primarily being affiliates of those members.[10]

However, as currently drafted, the definition likely would capture many more entities than apparently is anticipated by the CFTC or was intended by Congress. Without further revisions, small participants such as Northland could be considered swap dealers and become subject to the plethora of regulatory requirements applicable to dealers, including capital, margin, segregation, and business conduct requirements as well as special reporting duties.

The burdens that are associated with being a swap dealer are not warranted for a company like Northland that deals solely with eligible contract participants and that poses absolutely no systemic risk. To subject such companies to swap dealer regulations would be over-reaching and contrary to the intent of Congress to redress the problems in the OTC markets that contributed to the financial crisis. Moreover, subjecting a small company like Northland to the same regulatory burdens as large swap dealers would decrease competition in the swaps markets and unquestionably would increase costs for end-users who rely on companies like Northland to aggregate their *bona fide* hedges with others.

Therefore, Northland urges the Commission to revise the definition of swap dealer to make it clear that companies like it are not considered swap dealers for purposes of complying with the Dodd-Frank Act and the rules promulgated there under.

III. *De Minimis* Exception

The Dodd-Frank Act mandates that the CFTC "shall exempt from designation as a swap dealer an entity that engages in a *de minimis* quantity of swap dealing in connection with Transactions with or on behalf of customers."[11] However, the Commission's proposed definition of *de minimis* is so narrow that it is difficult to imagine an entity that would

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[9] *See* Oral Testimony of Chairman Gary Gensler before the U.S. House Committee on Agriculture, Public Hearing to Review Implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Feb. 10, 2011).

[10] *See, e.g.*, Written Testimony of Chairman Gary Gensler before the Senate Committee on Banking, Housing, and Urban Affairs, Public Hearing on Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act (Sept. 30, 2010) ("It is estimated that as many as 200 entities may register with the CFTC as swap dealers").

[11] CEA section 1a(49)(D).

qualify as a dealer but for the *de minimis* exemption. As such, the Proposed Rule would for all practical purposes eviscerate the statutory exemption.

The Commission proposes a three-prong test under which each prong must be satisfied: (i) the entity's swaps in connection with dealing activities must have had a gross notional amount of not more than $100 million during the preceding 12 months; (ii) the entity must have had no more than 15 swaps counterparties, other than swap dealers, during the preceding 12 months; *and* (iii) the person must not have entered into more than 20 swaps in connection with swap dealing activities during the preceding 12 months.

Notional Amount. The Commission's proposed $100 million notional amount threshold is completely unsupported by the record. As an initial matter, a monetary-based notional amount may not be an appropriate measure across the array of markets subject to this rule. For example, there are important differences between the notional amount for a commodity swap and the notional amount of an interest rate swap. While an interest rate swap will have a notional amount stated in dollars, the notional amount of a commodity swap typically is stated in terms of units of the commodity (*e.g.*, 42,000 gallons of heating oil). As such, the monetary notional amount of an energy swap changes from day to day with the price of the underlying commodity. This means that a market participant's gross notional amount can increase or decrease substantially without any change to the market participant's behavior, actual risk exposure, or relative size in the marketplace. Therefore, a better measure of relative size in commodity markets would be a commodity-specific non-monetary notional amount (*i.e.*, the units of the commodity).

If the CFTC chooses to use a monetary notional amount as a criteria for the *de minimis* exemption for commodities swaps, the CFTC should substantially increase the threshold and provide more guidance regarding how the notional amount should be calculated in the energy markets. Importantly, the Commission should clarify that the 12-month period to be considered is not a rolling 12-month period. Instead, in light of the impact that changes in the price of the underlying commodity can have on the notional amount, a company's eligibility for the *de minimis* exception should be evaluated based on the notional amount during the prior calendar year, or some other fixed measuring period, and there should be a grace period for registration if the threshold is surpassed.

Number of Counterparties and Swaps. Irrespective of the notional amount threshold, the thresholds for the number of counterparties and the number of swaps are completely arbitrary and capricious. The proposed levels are especially unreasonable so long as the Commission maintains its preliminary view that each of the three factors must be satisfied to qualify for the exemption. Although a small aggregator might fit within the proposed notional value threshold, companies like Northland easily can have hundreds of counterparties and, in light of the Commission's proposed treatment of separate transactions under a single swap master agreement, many times as many swap agreements. Considering the substantial burdens that would be imposed upon small swap dealers under the proposal, the levels should be increased and the criteria presented in the disjunctive.

The Commission suggests that its proposed threshold of 20 instruments is reasonable given the "customer protection issues raised by swaps ... including the risks that counterparties may not fully appreciate when entering into swaps."[12] However, any concern regarding the level of sophistication of counterparties is mitigated by the continued statutory requirement that off-exchange swaps are only available to eligible contract participants. Moreover, energy swaps, and particularly those offered by an aggregator, typically are relatively simple and the associated risk tends to be self-evident.

The Commission specifically requested comments regarding whether the *de minimis* exemption should excuse entities from certain compliance requirements and not others. Although such an approach could address some of Northland's concerns regarding the burdens that would be imposed on small dealer-types, to impose any dealer obligations on an entity with a *de minimis* swap dealing business would be contrary to the language of the statute which provides an unconditional exemption from even the designation swap dealer.

The Commission also requested comment as to whether the exemption should be self-executing. Because the Commission is proposing quantitative criteria, and because an entity's eligibility for the exemption can change over time, it would be a waste of resources to require entities to request and the Commission to entertain requests for exemptions. Therefore, the self-executing approach is most appropriate.

IV. Aggregators

Just as the Commission explained when it discussed the concept of an aggregator, Northland "enter[s] into swaps with other parties in order to aggregate the swap positions of the other parties into a size that would be more amenable to entering into swaps in the larger swap market, or otherwise to make entering into such swaps more efficient."[13] In this role, Northland efficiently rolls up the *bona fide* hedges of its customers into an aggregate position that can be managed more efficiently and cost-effectively.

As the rule currently is proposed, it is likely that many if not most aggregators would fail to qualify for the *de minimis* exemption. However, aggregators perform a very different function from swap dealers, and aggregators do not raise the same kinds of concerns or pose the same kinds of risks as swap dealers. As such, the Commission should clarify that aggregators will not be designated as swap dealers based on their activities as such. The Commission could address this issue either by clarifying the definition of swap dealer to clearly not reach conduct that amounts to aggregation or by expressly excluding aggregating activities from the definition of swap dealer.

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[12] Proposed Rule at 80,180.

[13] *See* Proposed Rule at 80,183.

Northland submits that adding the following language to the definition of swap dealer appropriately would exclude aggregating activities from triggering a designation as swap dealer:

> *Aggregator exclusion* – A person shall not be deemed to be a "*swap dealer*" as a result of activity with bilateral counterparties for whom swaps are entered into to establish a *bona fide* hedging transaction or position for the counterparty as defined in §151.5; provided such person (i) enters into such swaps predominantly in one direction (long or short) and (ii) offsets the risks associated with such swaps using regulated futures transactions or cleared, over-the-counter derivatives. For purposes of this exclusion, a person shall be deemed to enter into swaps "predominantly" in one direction if its swaps in the opposite direction considered independently would qualify for the *de minimis* exception defined in §1.3(ppp)(4).

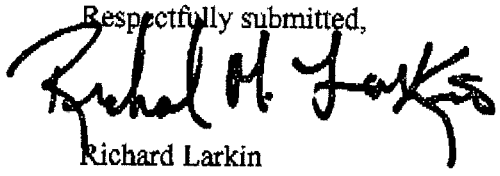
This language would narrowly tailor the exclusion to capture only those transactions that are conducted purely for the purpose of aggregating *bona fide* hedge positions to manage such positions in an efficient manner.

V. Conclusion

The definition of swap dealer, as currently proposed, is overly broad and exceeds the scope intended by Congress. To designated Northland and companies like it a swap dealer would jeopardize small companies' ability to provide this valuable service to end users and would thereby reduce competition and efficiency in the swaps markets. Therefore, the Commission should narrow its swap dealer definition, raise the *de minimis* threshold, and exclude aggregators' aggregating activities from the definition of swap dealer.

Please do not hesitate to contact us if you have any questions with respect to these comments.

Respectfully submitted,



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